1960

Corporate reorganizations: Simple as A B C!

Herbert M. Paul

Recommended Citation
Quarterly, Vol. 06, no. 2 (1960, June), p. 09-16

Corporate Reorganizations:

Simple as A B C!

by Herbert M. Paul
New York

Business management is often faced with the problem of whether or not to combine with another corporation which is in a similar, related or complementary field. In today's business climate it is becoming increasingly common for corporations to combine. The audit staff, while not responsible for the tax planning concerning a combination of businesses, should nevertheless be familiar with the various tax problems involved. This article will acquaint the staff man who is not a specialist in taxes with the various basic methods employed and principles involved in such combinations.

The decision to combine one business entity with another is a management decision which involves business considerations. As with many other phases of business, however, the tax consequences are vitally important if not decisive. For our purposes we shall distinguish and consider two classes of combinations: taxable and tax free.

A taxable combination is essentially the purchase of a business entity. For tax purposes this form of combining is considered as a completed and closed transaction. Thus the entire gain is considered as earned in the year of the transaction. The gain recognized is the difference between the tax basis of the property sold and the consideration received. As you can see, the taxable combination is treated the same as a purchase by one individual of stock owned by another.

Frequently the value of a company about to be combined with another has grown so large that tax on the gain involved in a taxable combination would be prohibitive. Accordingly, the usual form of combining business entities involves a tax-free combination or what is commonly called a tax-free reorganization. Actually, the term "tax-free" is a misnomer: what is really meant is a tax deferral or postponement. That is, the recognition of income is postponed until the property received in the exchange is finally disposed of in a closed and completed taxable transaction.

Tax-free treatment has been provided because of the feeling that certain situations which qualify as tax-free reorganizations do not involve a completed or closed transaction. There has merely been a change in the legal form of the corporations representing the investment, without any real change in the business holdings. The participants in the reorganizations do not wind up with anything more or less than they had before, although the form of their investment has changed. They retain a continuing economic interest in a new and enlarged economic enterprise.

The Internal Revenue Code[1] provides that no gain or loss shall result from specified transactions which qualify as reorganizations under the Code's definition of that term. In particular, no gain or loss is recognized to a shareholder if stock or securities in a corporation which is a party to a reorganization are, in pursuance of a plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation which is a party to the reorganization. Similarly, no gain or loss is recognized to a corporation which is a party to a reorganization if it exchanges property, in pursuance of a plan of reorganization, solely for stock or securities in another corporation which is a party to a reorganization.

The general rule stated above has one exception. If, in the reorganization, a taxpayer obtains a greater principal amount of securities than he had before the reorganization, then the reorganization is not completely tax-free. The term "securities" refers only to debt and not to stock. Thus a reorganization cannot be used to establish or increase debt due to shareholders and thereby conceal a distribution of profits, which should be treated as a dividend.

As can be seen, the key element of these tax-free transactions is that there be a combining of two corporate enterprises which qualifies as a reorganization. The Internal Revenue Code[2] specifically describes the various transactions which will be treated as reorganizations for tax purposes. Tax-free treatment is accorded to three specific procedures for combining businesses. The procedures are listed in subsections (a) (1) (A), (B), and (C), and are therefore referred to

(1) Section 354 (applicable to shareholders) and Section 361 (applicable to the reorganized corporations).

(2) Section 368 (a).

as the "A", "B" and "C" reorganizations. It should be noted that the requirements of the Code must be strictly adhered to before the tax-free treatment will be allowed. First, there must be an exchange pursuant to a plan of reorganization. Second, the special treatment will be accorded only to those corporations which qualify as a party to the reorganization or to shareholders who exchange stock of corporations which so qualify. Finally, the transaction must be one of those described by the Code. In addition to the requirements specified in the Code there have grown up, as a result of many court decisions, additional requirements which also must be met.

The "A" reorganization

The simplest type of reorganization is an "A" reorganization. It is a statutory merger or consolidation. A merger is the combining of one corporation into another corporation under the statutes of a particular state or country with the resulting survival of one of the participants; this survivor being the sum of the two participants. In contrast to this, a consolidation is the combining of two existing corporations into a newly formed third corporation. As in a merger, the newly formed corporation is the sum of the two participants.

Although the "A" reorganization is the simplest form from a standpoint of Code requirements, it is not the most commonly used. This is because in dealing with a statutory merger or consolidation, the transaction must be accomplished according to state law, and there are often many practical problems of complying with the legal requirements of the state or states of incorporation of the participants. Also, the right of dissenting stockholders to demand the payment of the fair market value of their stock can be an important factor.

The "B" reorganization

A "B" reorganization contemplates the acquisition by one corporation of control of stock of another corporation solely in exchange for voting stock of such acquiring corporation. This can be described as a stock-for-stock exchange.

There are requirements both as to the stock being acquired and the consideration given for it. The stock being acquired must give the acquiring corporation "control" of the acquired corporation. The term "control," when used in the reorganization sections refers to the ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of all other classes of stock of the acquired corporation. This requirement of 80% is higher than the percentage required to consolidate for accounting purposes. The SEC, for example, only requires "more than 50 per cent" control in order to consolidate for financial reporting purposes.

Regulations provide that the total stock owned which makes up the controlling interest need not be acquired in one transaction. A "creeping type" of acquisition is permitted wherein control of a corporation can be obtained over a period of time. The 80% requirement need only be met in regard to the particular acquisition for which tax-free treatment is desired.

In addition, it should be realized that the transaction will only be granted the special treatment if the block of stock which secures the required control is obtained solely for voting stock of the acquiring corporation. No other consideration is permitted. However, there is no prescription as to how much voting stock of the acquiring corporation must be given up. A "creeping type" of acquisition permits the prior acquisitions of stock of the acquired corporation for any property—say cash. Such a prior acquisition for cash is permitted as long as the non-qualifying transaction was independent of the qualifying transaction. If the immediate and previous acquisitions are found to be part of a general plan, then all the transactions will be considered together. If the acquisitions are linked together, then the requirement of acquiring control solely for voting stock of the acquiring corporation will not be met and the transaction will be taxable.

The "C" reorganization

The third type of reorganization used to combine businesses, a "C" reorganization, is a stock-for-assets exchange. Here there is an acquisition by one corporation, in exchange solely for all or part of its voting stock, of substantially all the properties of another corporation. Normally such a reorganization is followed by the liquidation of the transferor corporation and the distribution, tax-free, of the stock of the transferee corporation. The assumption by the acquiring corporation of liabilities of the other corporation is not treated as other consideration given—which would bar treatment as a tax-free reorganization.

It should be noted that although the "C" reorganization and a merger give the same results the "C" reorganization route is the one commonly used.

The statutory definition of a "C" reorganization specifies that "substantially all" of the properties have to be acquired, but nowhere is there found a definition of the term "substantially all." The Treasury Department has taken the position that "substantially all" the properties of a corporation are acquired if 90% or more of the net assets of the particular corporation are acquired. It is understood that when we talk of property, we are referring to the value of the respective properties and not their cost, size, weight or any other method which might be used for describing such properties. The retention of a reasonable amount of assets necessary to meet the obligations of the acquired corporation shall be disregarded in determining if the "substantially all" test is met. However, if assets are retained to pay liabilities and these assets turn out to be in excess of the liabilities, the distribution of such assets will probably be taxed as a dividend.

A variation involving the parent

There is a variation of the above-described third type of exchange which is permitted by the Code. This variation provides that the voting stock to be given up can be that of a corporation which is in control of the acquiring corporation. Such a corporation is commonly referred to as a parent corporation. Thus, the "C" reorganization adopts a consolidation approach: realizing that a parent corporation and its subsidiary should, in certain instances, be viewed as one. A subsidiary corporation can therefore receive properties which are the subject of a reorganization transaction in spite of the fact that the consideration for such properties is paid by its parent corporation, which is a separate legal entity.

In examining the variations just referred to, there is one point which must be carefully observed. Although the stock given up may be that of the corporation or its parent there cannot be any mixing. The stock given up must be that of the corporation *or* its parent and not the stock of the corporation *and* its parent. However, the property to be received in exchange for the stock can go to either the corporation or its subsidiary or subsidiaries, or part to the corporation and part to its subsidiary or subsidiaries.

(continued on next page)

There is an exception to the "solely for voting stock" requirement of the "C" reorganization. However, it is not often used because usually it will not be advantageous to do so. Thus, the Code provides that other consideration may be given in addition to voting stock and the assumption of liabilities where substantially all the assets of another corporation are being acquired. But in such case, the value of the stock given in consideration must equal at least 80% of the total gross assets of the other corporation. This means that the sum of the liabilities assumed and the consideration other than voting stock cannot exceed 20% of the total consideration given.

Some additional requirements

As mentioned previously, in addition to the aforementioned requirements set forth in the Code, there are certain principles laid down by the courts which must be complied with in order to obtain the desired tax-free treatment. The first such requirement is that of "continuity of interest." This test requires that in order to have a tax-free reorganization, there must be a substantial continuing proprietary interest in the reorganized business by the parties to the reorganization. There is a continuity of interest where a substantial part of the consideration received constitutes an equity interest in the surviving corporation. The substantiality is measured by the value of the assets transferred, rather than by the total value of all assets of the surviving corporation. The requirement of a continuity of interest applies to all reorganizations, but is emphasized in the "B" and "C" types of reorganizations by the Code requirement that the transferor acquire voting stock of the transferee.

The Supreme Court in the case of *Gregory v. Helvering,* 293 U.S. 465 (1935) laid down the now famous "business-purpose" test. In this case, the Court stated that a transaction, even though it literally complied with the requirements of the Code so as to qualify as a tax-free reorganization, will not be considered as such if there is no "business purpose." Thus there is a general requirement that a reorganization in order to be tax-free must have a bona fide corporate business purpose. The transaction cannot merely be a tax avoidance device.

In this regard it should be noted that if there is a substantial valid business purpose, the tax-free nature of a reorganization will not be disregarded merely because there is also incidentally a tax-saving motive. This falls under the general principle of tax law that if there are two ways of accomplishing a result, the taxpayer is not obligated to choose the method which will result in the greater tax.

The above-mentioned three types of reorganizations are the ones primarily used to combine business entities. However, there are three other types of reorganization prescribed by the Code.[3] These latter three are used either to divide an existing corporation or to merely modify the capital structure of an existing corporation.

The fourth type of situation which the Code defines as a reorganization is a transfer by a corporation of all or part of its assets to another corporation, if immediately after the transfer either the transferor, or one or more of its stockholders, or any combination thereof is in control of the corporation to which the assets are transferred. This reorganization is used only as a preliminary step in a corporate separation. Thus it is a method of splitting off a segment of the property of a corporation to a subsidiary corporation, the stock of which will in turn be distributed to shareholders of the parent corporation.

The fifth transaction which the Code defines as a reorganization is a recapitalization. Neither the Code nor the Regulations define the term "recapitalization." Case law, however, has stated that a recapitalization takes place where there is a reshuffling of the capital structure of a corporation. This reshuffling may be either of the debt structure or of the equity interests, or both, of the corporation. The primary reasons for recapitalizations are non-tax considerations. Some of these reasons are as follows:

(1) Improvement of corporate credit picture by replacing debt financing with equity financing.

(2) A more flexible capital structure which would, say, provide more attractive stock for corporate employees.

Recapitalizations involving the issuance of debt in exchange for stock resulting in the increase or creation of debt do not qualify as tax-free reorganizations.

A mere change in the identity, form or place of organization, no matter how effected, is classified as the sixth type of reorganization. This would include changing the corporate name or incorporating in a different state.

As mentioned above, the exchange is not tax-free, even though there is a reorganization, unless the exchange is made pursuant to a plan of reorganization. The plan of reorganization must be adopted

(3) Section 368 (a) (1) (D), (E), and (F).

by the proper officials of each of the participating corporations.

The term "party to a reorganization" includes a corporation resulting from a reorganization and both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another corporation. The corporation controlling the acquiring corporation is also a party to the reorganization when the stock of such controlling corporation is used to acquire assets of the acquired corporation. Also, a corporation remains a party to the reorganization although it transfers all or part of the assets acquired to a controlled subsidiary.

Every corporate party to a reorganization must file as part of its tax return for the taxable year in which the reorganization occurred, a duly certified copy of the Plan of Reorganization and a complete statement of all important facts in connection with the reorganization and the non-recognition of gain. All taxpayers who receive stock, securities, or other property in a tax-free exchange which is part of a reorganization, must attach a similar statement to their tax return. In addition to the information which must be supplied as part of the tax returns, each of the taxpayers involved must keep permanent records showing pertinent data regarding both the stock or securities given up and any stock, securities, other property or money received.

Although it is hoped that the above presentation makes reorganizations appear to be simple matters, the contrary is actually the truth. Great care must be taken in setting up a transaction to qualify as a reorganization and in determining its tax consequences. The safest course of action to pursue in making sure of the tax-free nature of a transaction is to secure a specific ruling in advance from the Commissioner of Internal Revenue stating the tax consequences of the proposed transactions. Such a ruling will be respected by the Internal Revenue Service as long as the completed transaction is substantially in accord with the facts stated in the ruling request.

Herbert M. Paul, ***New York***

Now completing work for an LL.M. at New York University in the field of taxation, Mr. Paul also has the following degrees: B.B.A. from the City College of New York, 1952; LL.B. from Harvard University, 1955; and M.B.A. from New York University in 1956. He joined our staff in 1957.